CUMBERLAND

NOW WHAT??

We've had a "relief rally" since last fall, so now what? The market is up almost 25% since the end of last year's third quarter.

We saw the same thing last year and in 2010 where a strong start to the year gave way to a market correction which gave it all back. In fact, last year's advance gave back almost 20% before bottoming on October 3rd based on fears that there was no hope for Europe and its debt burdened members.

Well, my bet is that this year will be different. In the short term, I think the market is probably over bought and due for a correction to consolidate the gains. But, I would use any set back as a buying opportunity. Europe is still a problem, but the Long Term Repurchase Operation (LTRO) fund that was put in place last December will "kick the can down the road". The U.S. economy is clearly improving and we won't face the same acute political paralysis that we saw last summer that froze business decision makers.

What swings the balance in favour of equities is the amount of cash that remains on the sidelines in investments earning only marginal returns. As I said in my last quarterly, equities still appear cheap relative to other alternatives such as bonds, real estate or gold.

So, the issues influencing the market haven't really changed very much but the perceived outcomes have gravitated from suicidal to something more rational. Maybe there is some hope after all. The U.S. didn't have a double dip recession and Europe didn't disintegrate.

Regardless, let me revisit some of these issues. Things are better but not all is well in the world.

Let's start with Europe. Last fall the concern was that the European sovereign debt crisis would escalate into a world credit crisis similar to what we saw in 2008.

Since then, the European Central Bank (ECB) established the Long Term Repurchase Operation (LTRO) which would lend European banks three year money at 1%. In December of last year, the ECB provided its first tranche of €645 billion and in February another €530 billion with 800 institutions participating. It seemed to be enough to forestall any near term default issue.

In March the European Finance Minister bolstered the plan by deciding to run the €500 million European Stability Mechanism (ESM) Pool alongside the European Financial Stability Facility (EFSF) Fund where there remains €240 billion of untapped resources, until 2013. This totals €940 billion ($1.3 trillion) when you include EFSF funds that have already been expended.

This combined with the LTRO seems to have settled the stock market's concerns. But for how long? Don't mistake the diagnosis of the problem for the treatment.

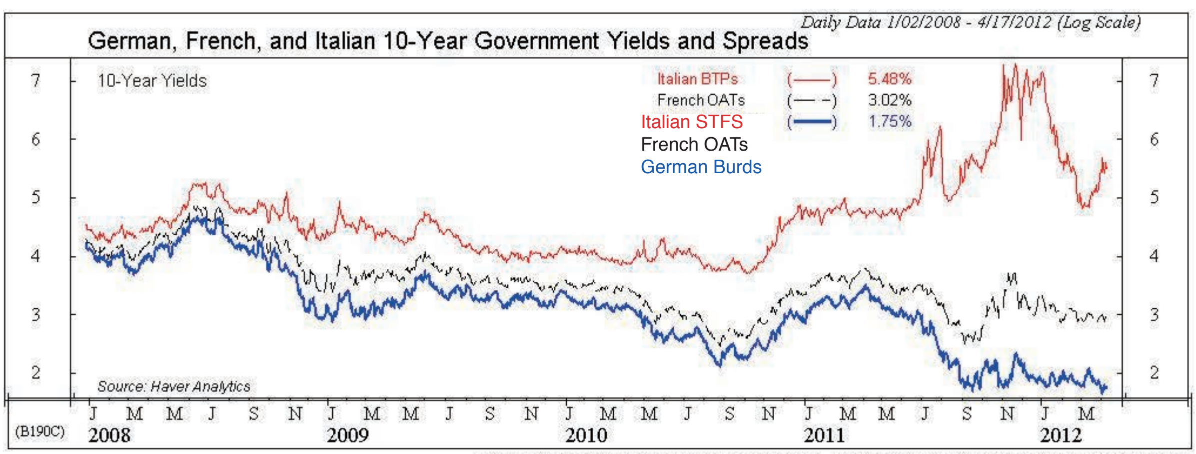
Solving the liquidity issues will only last so long. Bottom line, Europe needs to deal with economic growth. No one is proposing to pay off any debt. The goal is to buy enough time to improve the debt to GDP ratio which means there ultimately has to be economic growth.

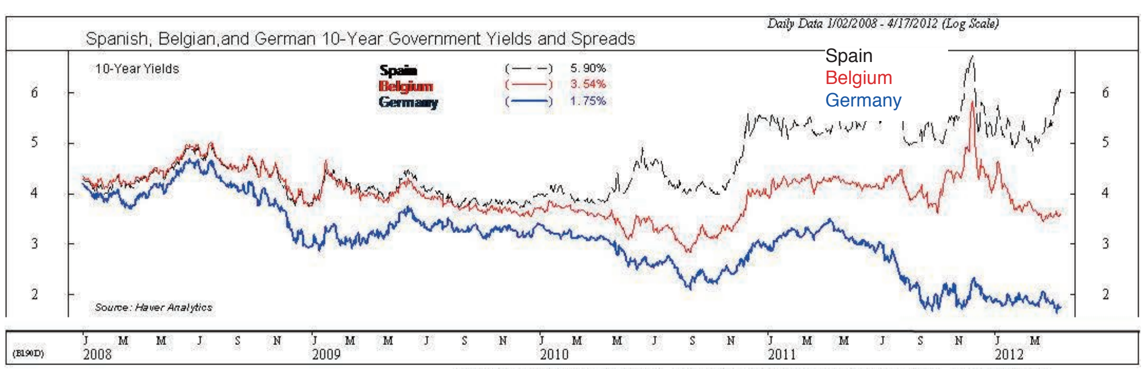
Austerity programs to cut government spending won't help with that objective but they will slow the projected borrowing requirements. Market forces have made this possible as sovereign access to the debt markets has been cut off unless assisted by the Central Banks. If this debt problem is to be solved, it will require a second phase that incorporates a growth strategy. Again, the crisis atmosphere is going to help reverse an over dependence on government and social programs while demanding more personal responsibility.

To this end, both Italy and Spain have proposed pro-growth strategies of deregulation and loosened labour laws.

All of this is a step in the right direction; it's only a question of whether the stop gap funding measures have bought enough time.

The markets vote on this every day and right now they have some doubts. Take a look at the top line in both of these charts.



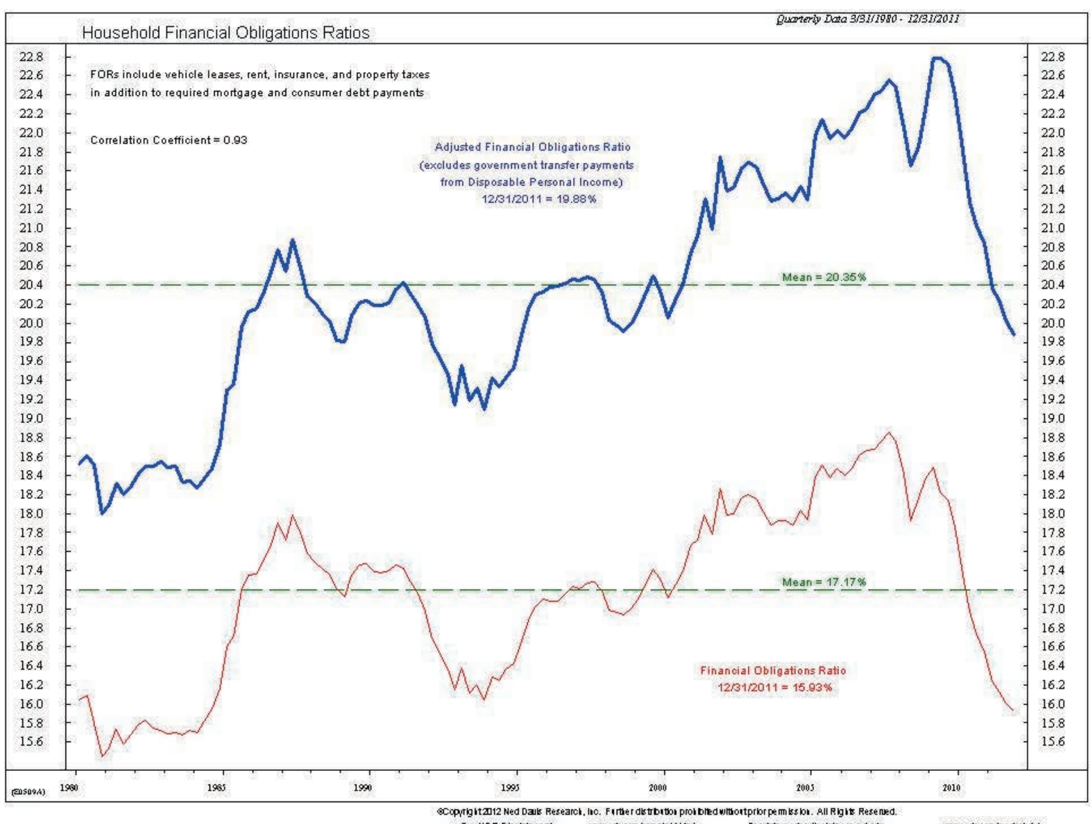


The first one is the yield on Italian ten-year bonds which have moved back above 5 1/2%. Not back to the peak of last fall, but certainly off the lows. The top line of the second chart is the Spanish ten-year bond yield. It's at almost 6%, well off the lows and approaching the previous peak, and even higher than before the LTRO.

Let's hope this doesn't become more acute. Spain's unemployment is approximately 24% and their economy is twice as big as Greece, Ireland and Portugal combined.

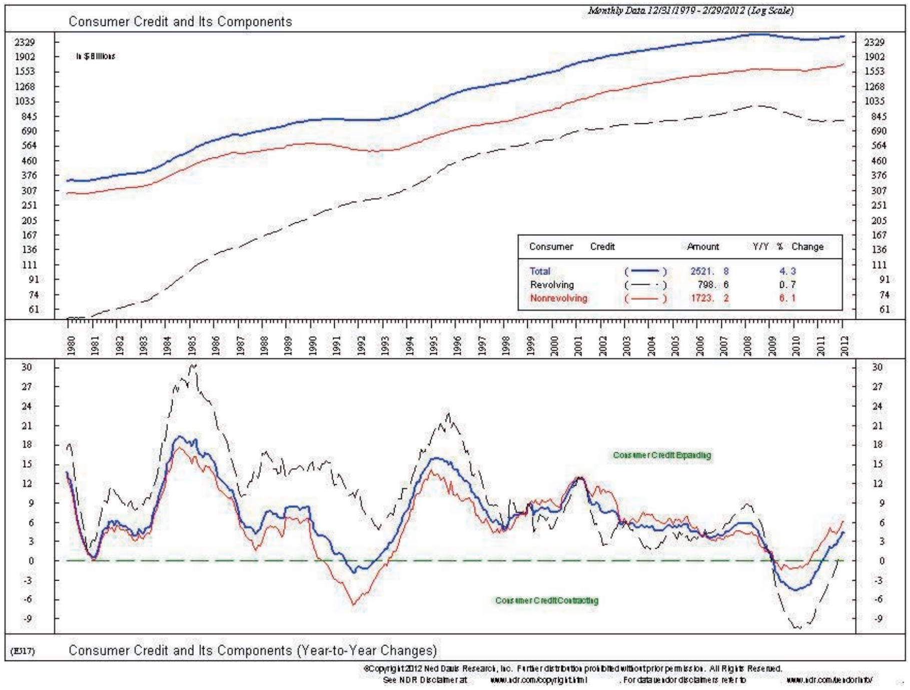
What's troubling is that this rise in Spanish yields has taken place while Spanish banks borrowing from the ECB has risen almost 50% to €228 billion in March. Most of this went to buy government bonds where holdings climbed to €246 billion. So far this year, Spain has sold €45 billion of debt but needs to raise another €47 billion.

The U.S. economy was also a concern last year but this seems to be correcting itself. Surprisingly, the strength has come from the perceived over leveraged consumer. To understand this, one has to first look at the consumer's capacity to borrow. Total debt is still high but has contracted considerably. However, when you look at what one spends on debt payments for mortgages, autos, consumer debt payments, etc. as a percentage of disposable income, it is at a 28 year low according to the Federal Reserve.



You can see in the bottom clip of the above chart that the obligation ratio has fallen from 18.9% in 2007 to 15.9% at the end of last year. Consumers may have finished deleveraging.

Are they using this capacity? It would appear so. Consumer credit rose $17.8 billion in January to $2.51 trillion for the biggest three month gain in more than a decade.



The bottom clip of this chart shows total consumer borrowing picked up about seven months ago with revolving debt (i.e. credit cards) only recently becoming positive.

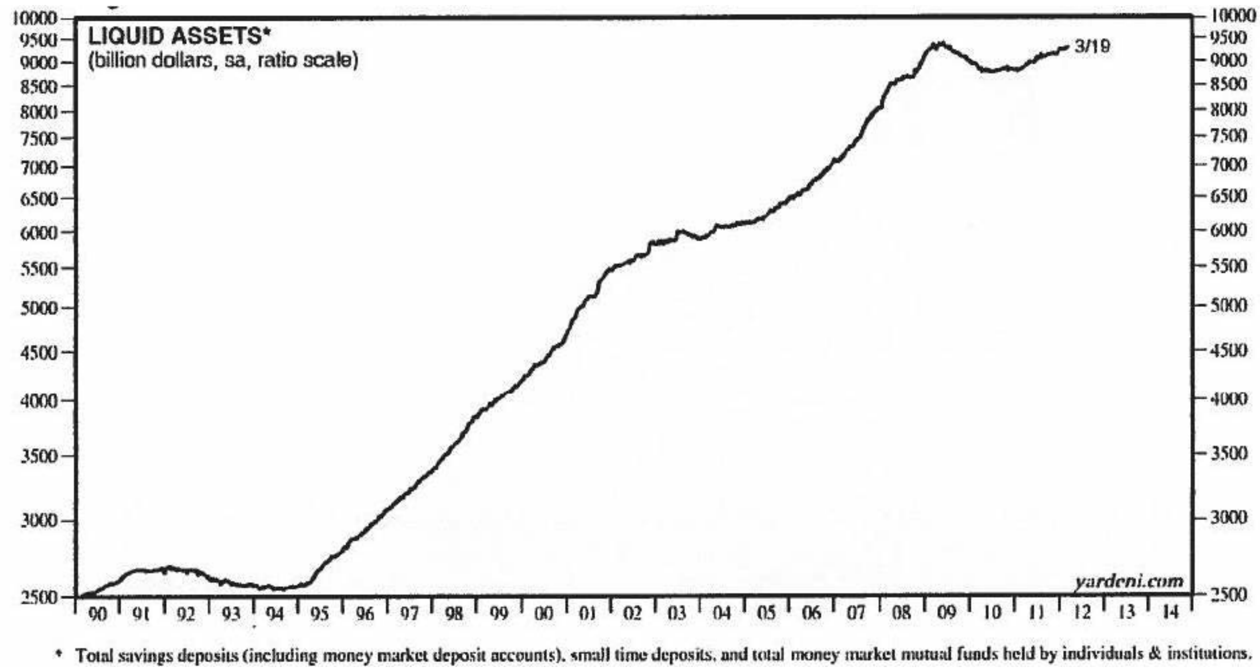
What is interesting is that most of the debt increase is due to student loans. If they are excluded, consumer credit is almost unchanged in the last year.

Student loans do help the economy, but it would appear that the consumer has a lot further to go if they want to ramp up their borrowing.

So, it's possible that the pickup in spending is more related to confidence, resulting in lower savings plus employment growth, which recently showed the best six month increase since 2006. Both could be considered a positive for sustained consumer spending growth.

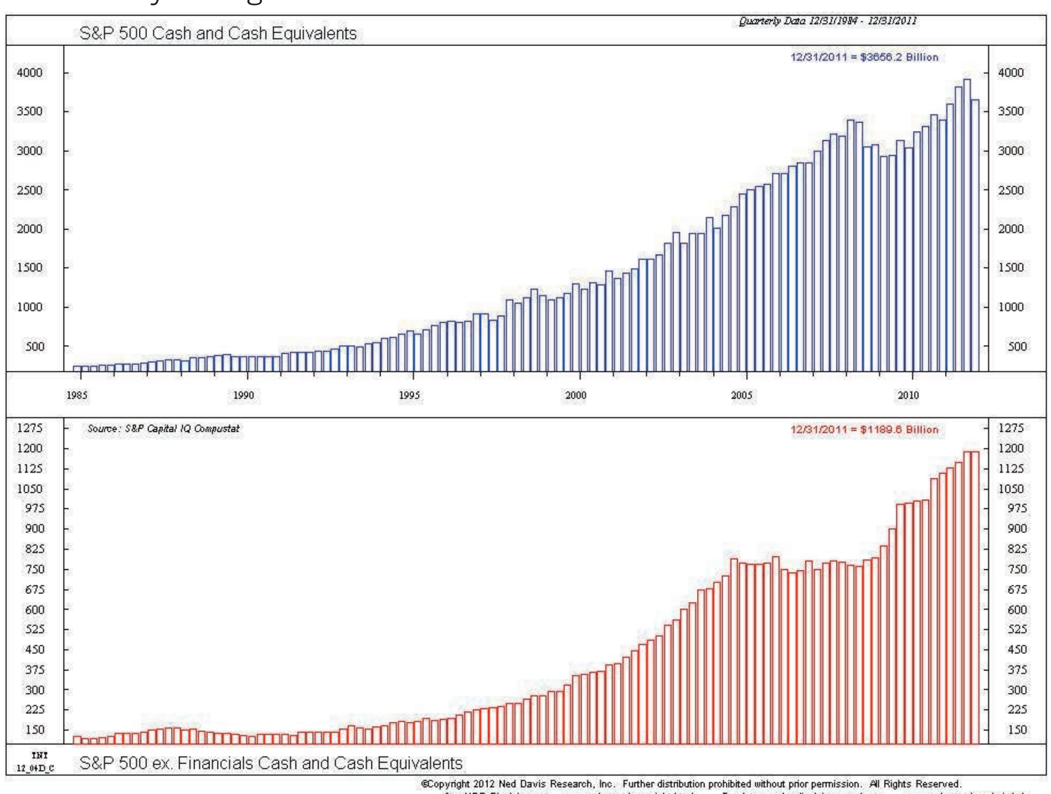
As a result, things are either stable or improving in Europe and in the U.S. economy. If one needs a tie breaker on the market, my nod will always go to liquidity.

Right now, money sitting on the sidelines with anemic returns is enormous.

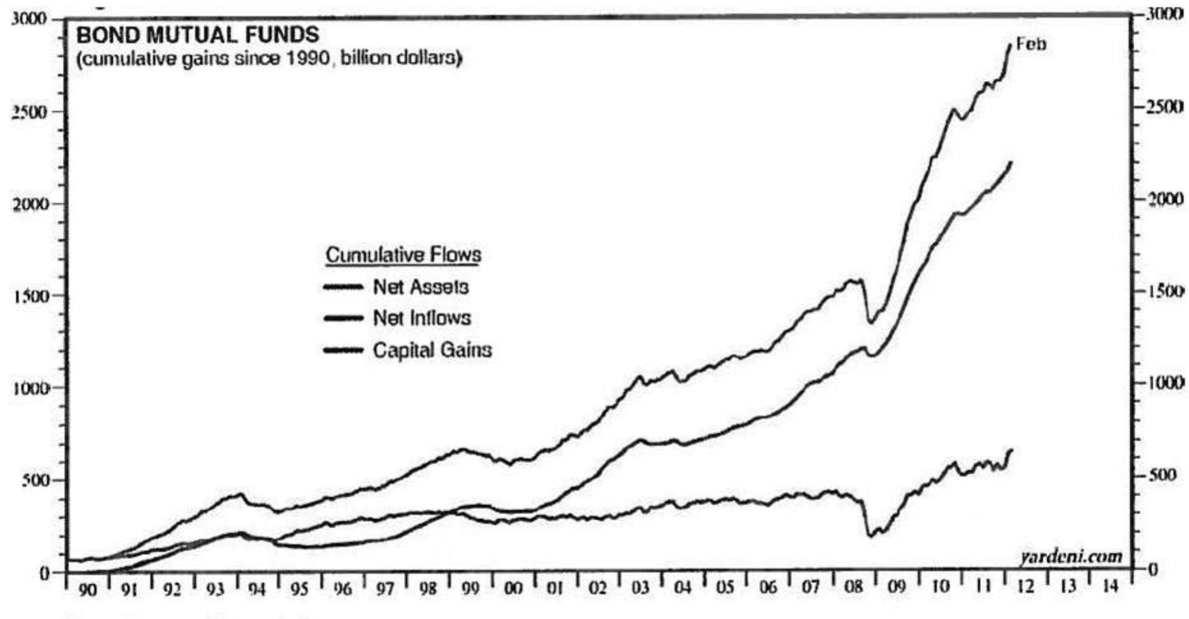


This chart quantifies total savings and includes bank deposits and money market funds. At the end of March, it totaled $9.3 trillion, almost matching its June 2009 record high.

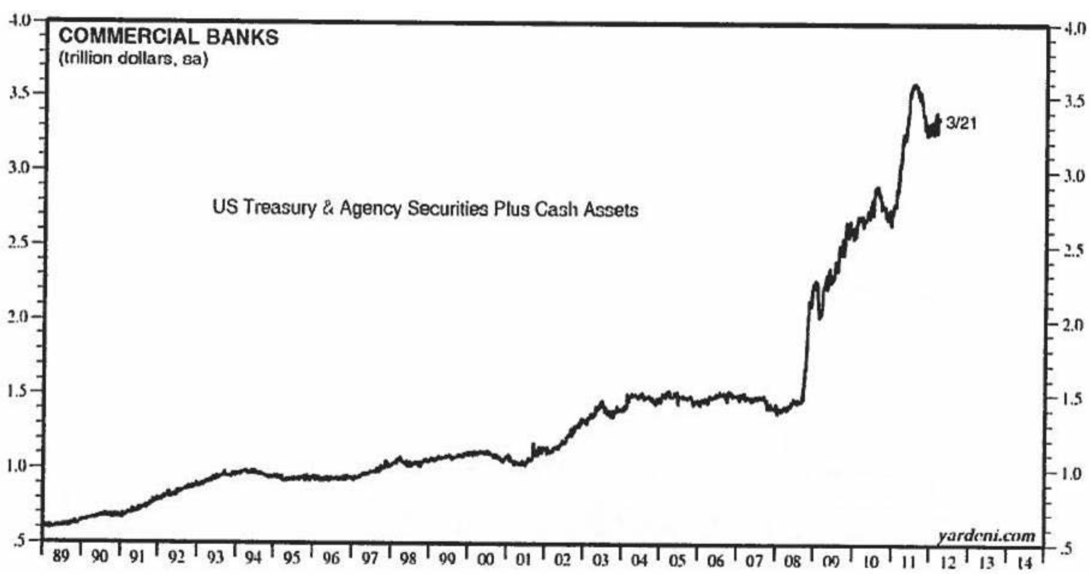
Who does all this money belong to?



Well, it's estimated that $3.7 trillion belongs to corporations including financials. For corporations, this ratio of liquid assets to short term liabilities is the highest since 1954.



On top of the savings, one might consider bond funds as a future source of equity demand. Over the last three years, $1 trillion has flowed into these funds. During the same period, equity mutual funds saw little inflow. Did that defensive move pay off? Well, equity funds realized $2.7 trillion in capital gains while bond funds showed gains of just $437 billion. Let's see what happens when interest rates start to increase and bond valuations decline.



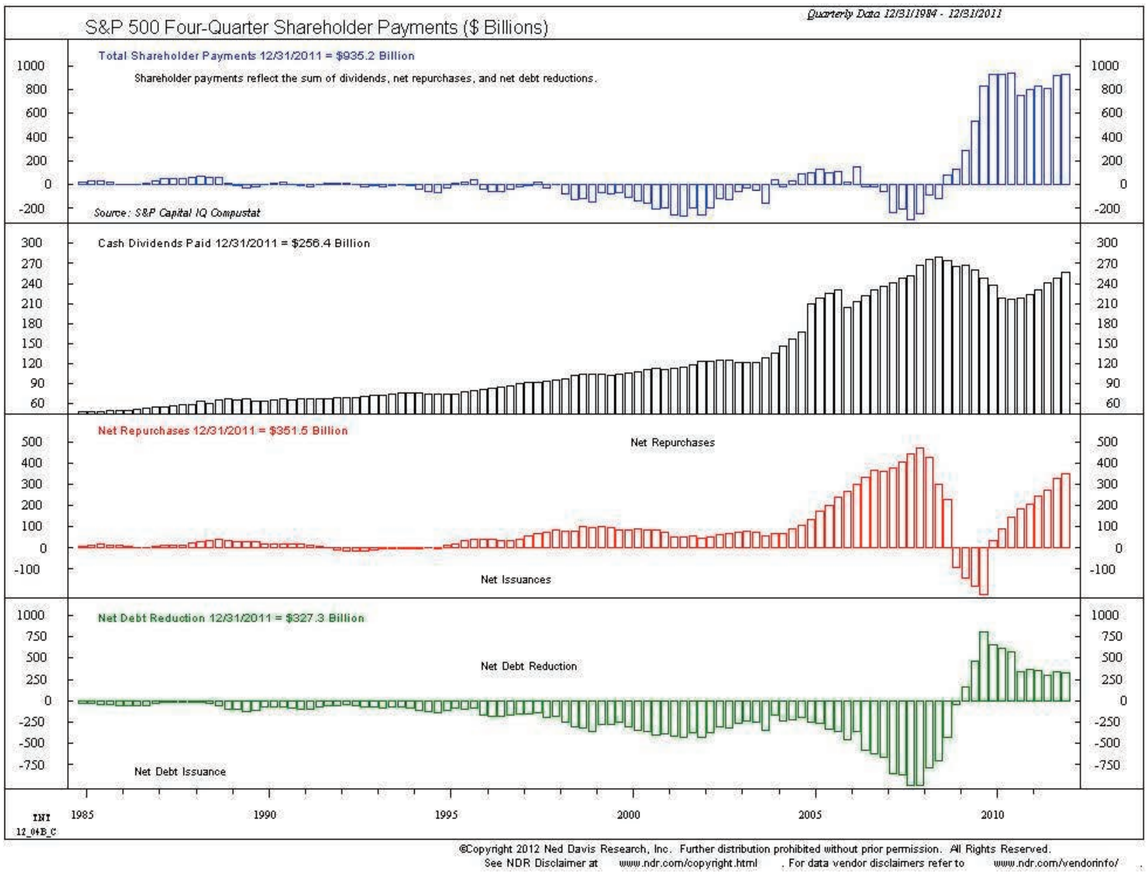
Source: Board of Governors of the Federal Reserve System.

U.S. banks are also sitting on $1.77 trillion in U.S. treasuries and agencies as well as nearly $1.6 trillion in cash.

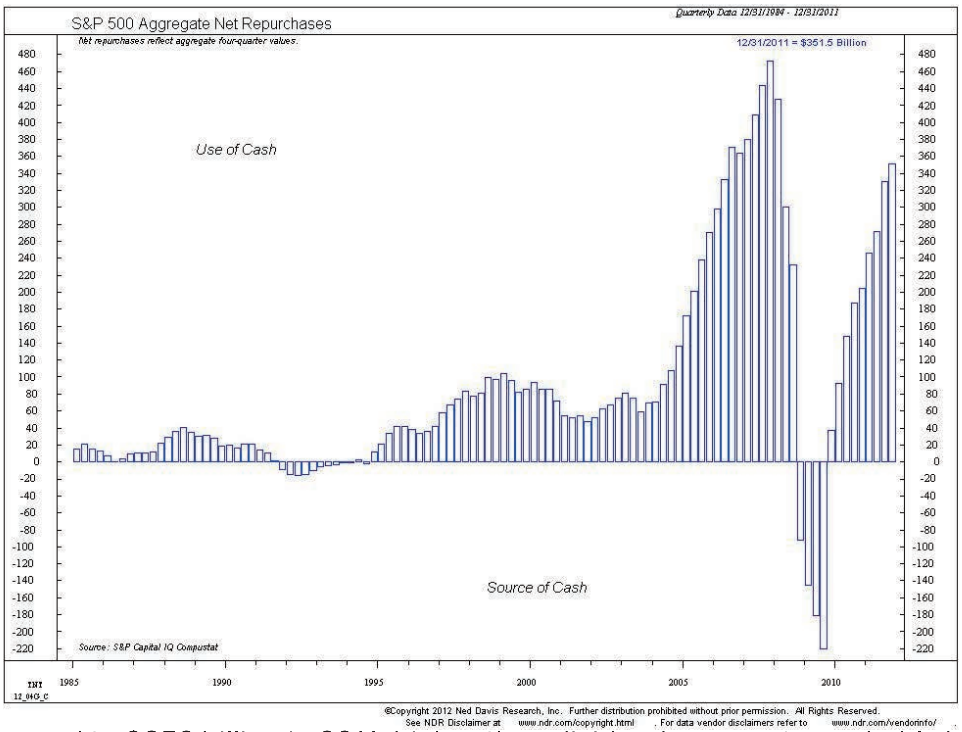
Summary

Last quarter, I did a fairly extensive review of what corporations could do with their cash. The options involve: (1) keeping it; (2) paying it out to shareholders through share repurchases and increased dividends; (3) debt pay-downs; (4) making acquisitions; and (5) increasing capital expenditures.

Even with the market rally that we have witnessed, very little has changed.

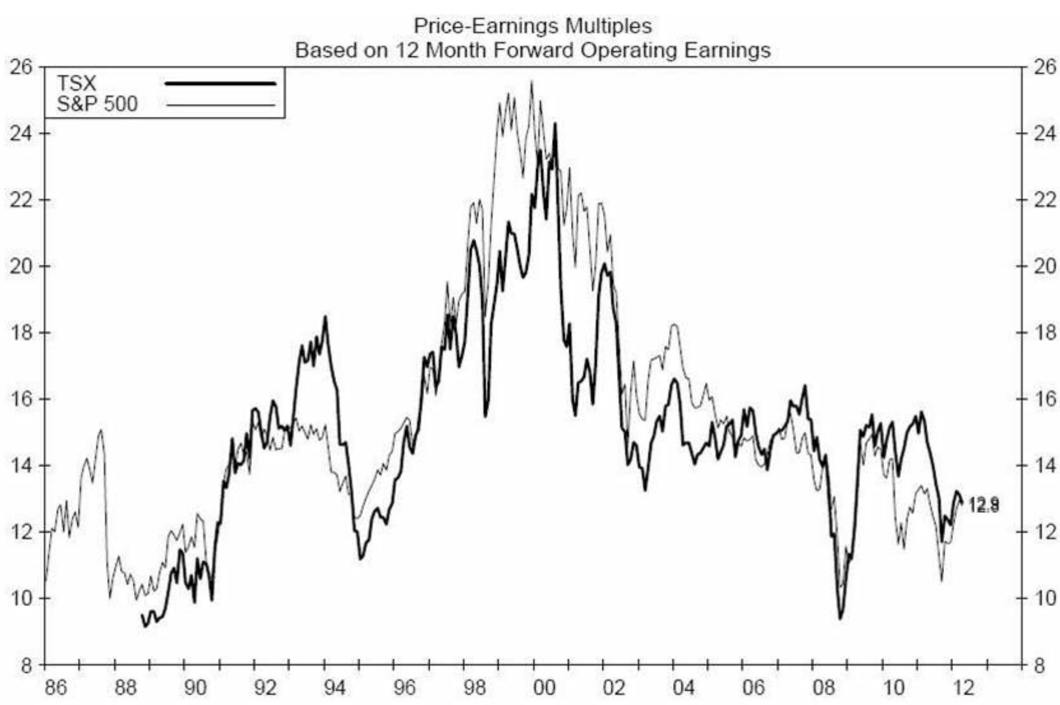


In the last four quarters, dividends, repurchases, and debt reduction has totaled $935 billion, as seen in the top clip of the above chart. Of this amount, dividends amounted to $256 billion, but as a percentage of earnings they remain at historical lows.



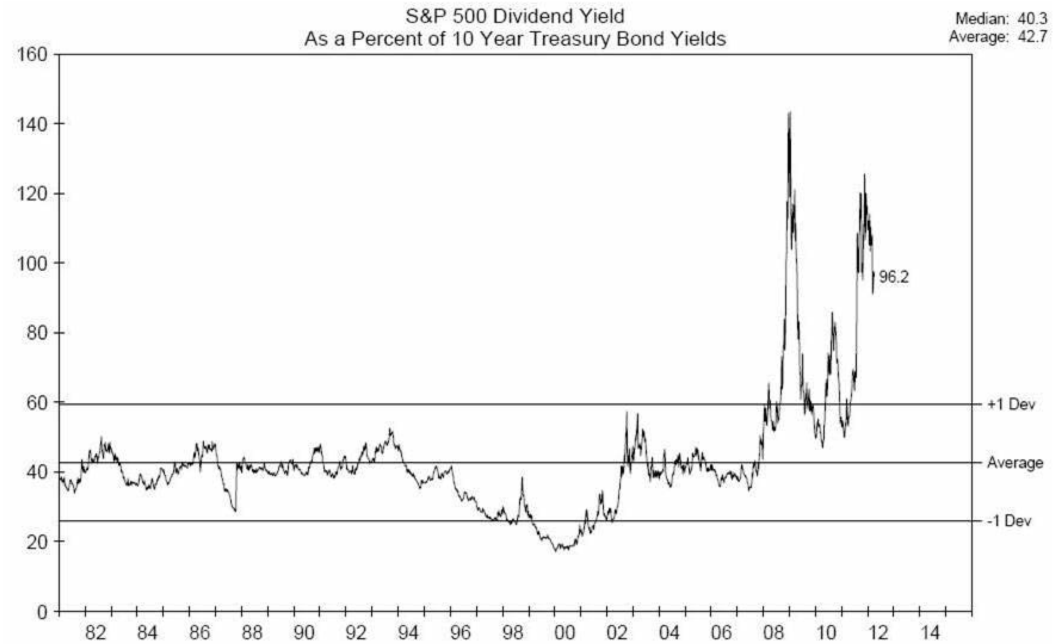
Repurchases recovered to $352 billion in 2011, higher than dividend payments, probably because corporations feel their shares are undervalued.

On a valuation basis, the markets are still inexpensive as measured by the price earnings ratio (p/e).



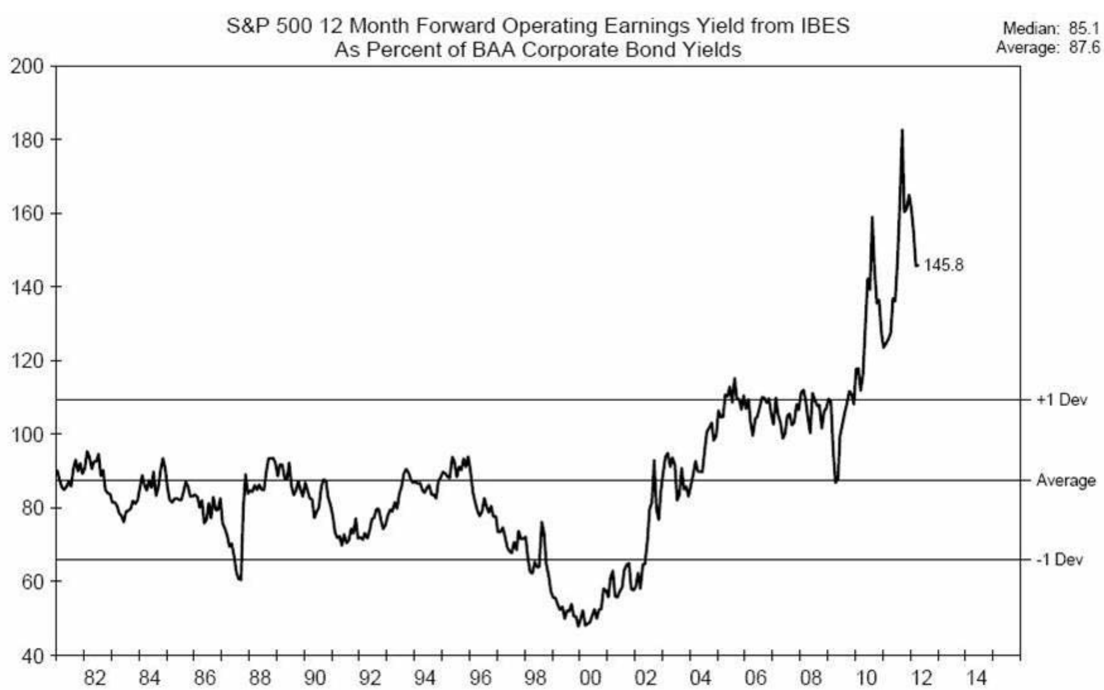
This chart shows the forward p/e ratios for the TSX and S&P 500. They're both down around 12.8x, well below the average of about 16x.

When comparing share valuations to bond yields, there is no contest.



This first chart compares the S&P 500 earnings yield (i.e. per share earnings divided by share price) to corporate bond yields.

This next chart compares dividend yields to government bond yields.



In both cases, stocks are at almost record low valuations.

With compelling valuations and record amounts of cash sitting on the sidelines, it's hard to make a case for much more than a market correction.

In my opinion, corporations will lead the way with individual investors eventually following.

In the face of perceived problems, and there are some, the average investor will probably remain on the sidelines. But as concerns get resolved, savings will gradually migrate from underperforming asset classes, especially savings, into riskier investments like equities where the returns are better.

Until that happens, the sidelined cash will provide a margin of safety in a still unsettled world.

April 10, 2012

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